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TAGS: ECON EFIN EMIN PGOV EINV ENRG ZA
SUBJECT: IMF Mission Supportive of New Mining Tax Regime,
Concerned with Power Situation

Refs: A) Lusaka 115; B) Lusaka 108 and previous

1 (SBU) Summary: A visiting IMF team commended Zambia's economic management and the government's commitment to improving public expenditure management and establishing a single Treasury account. The team discussed the basis for changing the mining tax regime, and raised concerns about the electric power situation. Post worries that IMF advice on reform of the government utility and project viability may not be heeded. End Summary.

¶2. (SBU) Background: IMF staff mission leader Francesco Caramazza and his colleagues briefed donor representatives at the beginning and end of a February 13-27, 2008 visit to Zambia. Caramazza reported that the mission discussed a new "low-access" Poverty Reduction and Growth Facility (PRGF) with Zambian officials, and that staff would present the terms of an arrangement to the IMF Board for approval in May 2008.

Upbeat View on Economic Outlook

¶3. (SBU) The IMF team offered an upbeat take on Zambia's macroeconomic outlook. The team expects 2008 real economic growth to rise slightly, to 6.3 percent, though falling copper prices and further electricity shortages could exert downward pressures on growth. The target for the annual rate of inflation is seven percent for 2008, and five percent for 2009, but external factors (such as weather, which affects food production) could have a negative impact on inflation. Caramazza told donors that the IMF was not worried about overly restrictive monetary policy curbing economic growth. He also said tQt the IMF does not expect a strong, sudden appreciation of the kwacha, as occurred in late
¶2005.

¶4. (SBU) Caramazza commented that the GRZ's 2008 budget proposal contained higher spending on education, health, and infrastructure, as well as funds allotted to paying off domestic arrears. The IMF also anticipates higher levels of non-mining revenues due to increases in government fees (Ref A). The IMF and donor representatives agreed that effective use of funds by line ministries remains a concern. In the new PRGF arrangement, the IMF expects to address structural issues, including public expenditure management, single Treasury account, budget execution, tax administration, and debt management.

¶5. (SBU) The DCM commented on the GRZ's reluctance to take on new debt obligations since HIPC completion in 2005, and asked the IMF team its position on incurring new debt. Caramazza explained that the Fund continues to encourage the GRZ to take new loans for investment, including infrastructure projects, on a concessional basis, and had not entirely discouraged new debt.

Questions on New Fiscal Regime for Mines

¶6. (SBU) The staff mission leader welcomed the increased revenues expected from the new mining sector fiscal regime, and the GRZ plan to place revenues into a special account to be used for capital expenditures. Donors raised questions about the mining tax regime (Ref A), in particular the debate surrounding the calculation of the effective tax rate. The Zambian government claimed that the effective tax rate was 47 percent, but mining sector representatives claimed it was as high as 79 percent. The IMF team observed that calculations can vary widely, depending on the timeframes used, the competitiveness of the specific company, and on different assumptions about copper prices. For example, the IMF expects declining world prices for copper, while the GRZ's projections keep prices at their current levels. Caramazza told donors that the GRZ promised to implement the new taxes in a way that takes into account the industry's concerns. He also noted that when copper prices fall, the issue might "disappear" entirely.

¶7. (SBU) P/E Chief questioned Caramazza on the sidelines of the meeting about the Fund's view of the GRZ's possible breach of contractual obligations. He explained that the GRZ and some donor-funded technical advisors conducted a benchmarking exercise to compare Zambia's tax regime to those of other copper-rich countries, and built financial models for all the mines operating in Zambia to test different taxation options. Based on the benchmarking and modeling, he thought the revisiting the "development agreements" with mining investors was justified. A written statement issued by the staff mission acknowledged concerns about reneging on contractual commitments by noting "In implementing the new regime, particular care needs to be taken to maintain Zambia's attractiveness as a destination for mining investment." Caramazza also noted that mining company-GRZ tensions reported in the local media were exaggerated and told donors that the GRZ would meet with mining companies during the week of March 3, to discuss the tax regime in more detail.

Energy Problems Critical

¶8. (SBU) Caramazza expressed concern over the electricity supply crisis (Ref B), and in a written public statement the staff mission stated, "Urgent action is needed to ensure that additional power generating capacity can come on line as soon as possible." He observed that the electricity rate hikes recently approved for national power utility ZESCO were insufficient to cover costs, so higher rates that better reflect costs are still needed. He also acknowledged that reform of the inefficient state monopoly is also critical. The team also observed that the GRZ would have to consider external borrowing to finance new generating capacity, and cautioned that the projects be viable, in the interest of debt management and sustainability.

¶9. (SBU) After one donor representative voiced dismay during the February 13 in-brief over the GRZ's lack of a sense of urgency about the electric power situation, the IMF team reported on February 27 that the GRZ has "recognized the problem." The team shared its view that the GRZ has greater political will to address the problem, in comparison with the past. Caramazza and his colleagues encouraged donors to consider seriously how they could support improvements in the power sector.

¶10. (SBU) The staff mission leader also advised that the GRZ was developing an energy sector policy paper for Cabinet approval. The paper targets three areas: 1) adjusting tariffs upwards to reflect costs better; 2) improving operational efficiency of ZESCO; and 3) improving environment for private sector investment.

¶11. (SBU) Comment. The IMF team's upbeat but qualified assessment of Zambia's economic outlook tracks with ours and other donors' views. However, we remain concerned that despite the IMF'S prescription to improve ZESCO's operational efficiency and to focus on economically viable power projects, the GRZ may take advantage of the current crisis to push through insufficiently-vetted projects, and ignore the need for ZESCO to reform its management, personnel and technical infrastructure.
MARTINEZ